

OSBD ISSUES

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Effects of 2001 Changes in Federal Taxes on Kentucky

THE ISSUE

The Economic Growth and Tax Relief Reconciliation Act of 2001, signed into law by President Bush on June 7, 2001, will reduce federal taxes by \$1.35 trillion over the period 2001 – 2011. The majority of the tax savings come from the reductions in individual income tax rates, including but not limited to, the tax rebate (\$875 billion); an increase in the child care tax credit (\$172 billion); the phase-out of the estate and gift tax (\$138 billion); and the elimination of the marriage penalty (\$63 billion).

THE CHANGES AND THEIR EFFECTS

For Kentucky taxpayers, the new tax law is a double-edged sword. While it means more money in individuals' pockets to spend, it also means lost revenue to the state. Provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 passed in May of this year provide tax savings to many individuals. Most of these tax savings come in the form of lower tax rates on individual income; an increase in the child care tax credit; phase-out of the estate and gift tax; and the elimination of the marriage penalty. In addition, a one-time tax rebate was put into effect the fruits of which many Kentuckians have already enjoyed.

The phase-out and repeal of the estate tax will directly reduce the General Fund tax receipts in the Commonwealth. Federal law allows a credit against the federal liability for state death taxes paid. Although taxpayers will continue to pay estate taxes, there will be a reduction in the state credit applied to their tax bill and the federal government will receive a larger proportion of the tax monies. Currently, Kentucky taxpayers calculate their federal estate tax and claim a credit on their federal return equal to their Kentucky death tax liability and any death taxes paid to other states. The tax plan reduces the state death tax credit rates and thus Kentucky's tax receipts fall. According to the Center on Budget and Policy Priorities, approximately two-thirds of the states face a total loss of estate tax revenue as a result of the federal repeal. By 2010, when the repeal will be fully effective, the combined loss to the states will approach \$9 billion.

The amount Kentucky stands to lose because of the repeal of the death tax could actually be higher than forecasted as future estate tax revenues were expected to increase because of the aging, wealthier population. Nationally, estate tax revenues for the states were expected to grow by approximately 60% over the next 10 years. Kentucky will also see a loss in General Fund tax receipts relative to the increase in the amount of the estate that will be excluded from taxation.

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Between now and the year 2010 when the tax act is fully in effect, the General Fund will fall by \$253 million as the loss of the estate tax outweighs the benefits of increased spending resulting from the tax cuts on individual income. FY01 saw no effect since taxpayers did not begin receiving refund checks until late July or early August at the earliest. For the current fiscal year (FY02), Kentucky's General Fund can be expected to increase since the estate tax reduction will not have an offsetting effect until the following year. From FY03 until FY11, General Fund receipts are expected to decline, with a maximum loss of \$48.7 million occurring in 2011.

THE BOTTOM LINE

The Governor's Office for Economic Analysis (GOEA) has estimated that Kentucky taxpayers will pay over \$11 billion less in federal taxes between now and 2010. The annual tax savings for Kentuckians range from \$822 million in FY2003 to \$1.7 billion in FY2010 (see Table 1 below). By putting more money in the pockets of Kentuckians it is expected that they will spend more on restaurant meals, appliances, clothing, and other taxable items. This in turn should result in an increase in sales tax receipts and thus an increase in General Fund taxes to support the services provided by state government. Purchases of automobiles will increase motor vehicle usage tax and raise Road Fund tax receipts. The Road Fund is expected to show an increase of \$45 million in receipts since the only influence on it is the increase in spending. The annual Road Fund increases are relatively small and gradually increase from \$3.2 million in 2002 to \$6.3 million in 2010.

Our initial analysis of the new tax plan shows Kentucky taxpayers will benefit from lower federal income and estate tax payments but Kentucky tax receipts overall will fall throughout the life of the tax plan. How the events of the September 11th terrorist attacks on New York and Washington, D.C. will affect the overall economy and consumer confidence, and ultimately the economy of the state, is not yet clear. Additional tax policy changes may also result from these events.

Table 1
Federal Tax Reduction for Kentucky Residents

(Millions of dollars)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2001-11
Reductions in Income Tax Rates	-779.7	-574.6	-648.5	-693.4	-845.6	-965.6	-1,035.1	-1,086.3	-1,128.6	-563.8	-7,757.4
Reduction of Marriage Penalty	0.0	-5.8	-11.3	-47.1	-86.8	-102.7	-101.2	-98.6	-90.9	-53.1	-544.3
Repeal of Estate & Gift Taxes	-0.7	-50.7	-57.2	-68.3	-51.5	-84.6	-114.0	-125.0	-201.2	-445.3	-753.3
Promotion of Education	-18.0	-31.3	-39.4	-44.2	-31.5	-23.3	-23.6	-26.2	-29.1	-14.7	-266.6
Increase in Child Tax Credit	-71.9	-93.8	-100.3	-117.8	-162.8	-181.0	-185.6	-194.5	-231.1	-249.6	-1,338.7
Pension/IRA Provisions	-13.7	-34.1	-42.3	-49.0	-54.6	-52.2	-50.3	-55.8	-62.8	-50.7	-414.8
AMT Relief and Miscellaneous	-17.6	-32.2	-47.8	-45.4	-16.6	-8.4	-8.7	-8.7	-8.7	-6.5	-194.0
Net Total	-901.6	-822.5	-946.8	-1,065.4	-1,249.3	-1,417.8	-1,518.4	-1,595.0	-1,752.3	-1,383.7	11,269.2

Note: The total federal tax reduction is less than the reported \$1.34T because Kentucky's fiscal year is different from the federal fiscal year.